Eurozone - FX

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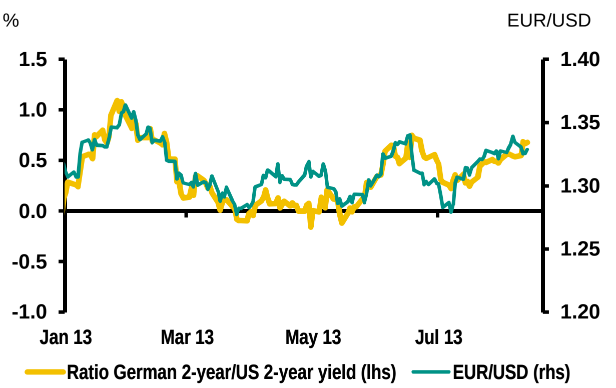
EUR/USD

EUR/USD

Ratio Germany/US 2-Y government bond yield

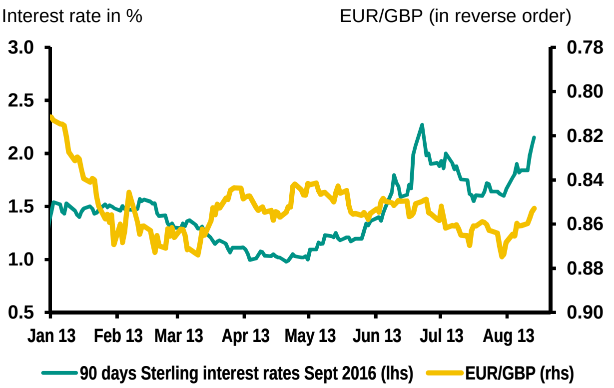


Source: Thomson Reuters Datastream

One of the themes we have been stressing is that the euro is a very interest rate sensitive currency. Better-than-expected eurozone data last week pushed German yields higher and this gave support to the EUR. The exception to the rule was against the dollar, with EUR/USD moving lower in the first part of the week. US data also have come in better and they pushed US yields up. The USD received support from higher yields up to the moment that the market started to become nervous about the Fed tapering. When the VIX started to move higher last Thursday and US equity market fell, the USD gave back its recent gains and EUR/USD moved back above 1.3350. We believe that strong US growth will in the end calm down markets and improve investor sentiment. The combination of stronger-than-expected US data, higher US yields and positive sentiment is likely to prove to be a powerful force pushing the USD higher versus the EUR. In addition, we expect the ECB to further dampen monetary policy expectations and short-term eurozone interest rates. We keep our forecast in EUR/USD at 1.20 in EUR/USD for the end of this year.

EUR/GBP

EUR/GBP, interest rate expectations

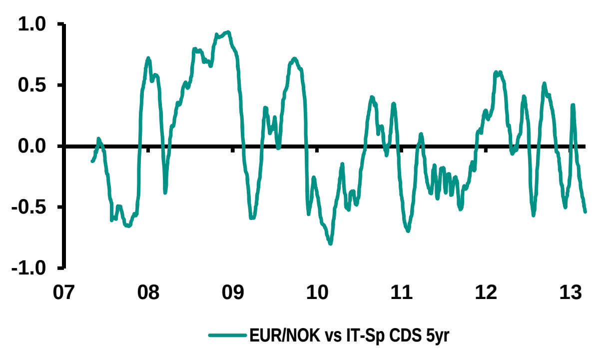


Source: Bloomberg

Two weeks ago, the BoE linked the timing of its first rate hike to a 7% unemployment threshold. According to the MPC's projections, the unemployment rate will not hit the 7% threshold until Q3 2016. The market, like us, did not buy into this idea. We expect the unemployment rate to drop at a faster rate than the BoE's projections. Therefore, it is unlikely that the BoE will remain on hold until Q3 2016. Last week, the better-than-expected jobless claims and retail sales data proved our point. As a result, EUR/GBP moved closer towards 0.85 (GBP up), while GBP/USD rallied towards 1.56. We expect headwinds for GBP/USD around current levels as the pressure on the USD has gone too far. Although we expect the BoE to reduce monetary stimulus before its own projections, US growth will outperform that in the UK. Therefore, the rally in GBP/USD is becoming vulnerable. In EUR/GBP, the GBP rally has more to go and we expect it to fall to 0.84 at the end of September.

SEK/NOK

EUR/NOK, average Spanish/Italian CDS spread



Source: Bloomberg

The Swedish krona (SEK) has started to strengthen versus EUR in line with our base case. But the move came abruptly to a halt because market sentiment deteriorated as a result of uncertainty about the Fed tapering. We expect sentiment to improve and economic data to continue to firm leading EUR/SEK to move towards our September forecast of 8.25. In Norway, higher-than-expected inflation and growth data resulted in expectations that the Norges Bank may need to increase interest rates. Higher yields are usually supportive for a currency if growth is strong and the sentiment risk seeking. The fact that higher yields in Norway did not support the NOK suggests that investors doubt the growth outlook. Moreover, eurozone investors may switched out of Norwegian bonds into peripheral bonds with the aim to reduce currency risk and bond price risk. We expect the Norwegian economy to improve as well so higher rates should then be able to support the NOK versus the EUR. We keep our forecast of 7.5 in EUR/NOK in place.

US - Economy & Rates

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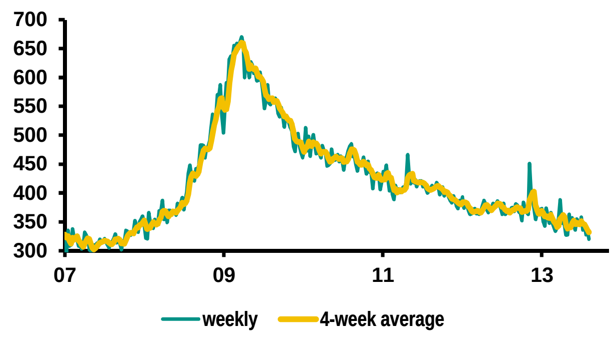
Economy

Initial jobless claims fell further last week, down to 320K from 335K the week before. This was the lowest level since October 2007. The trend in claims is convincing and supports other evidence pointing to a rebound in job growth in August, following July's slip. Meanwhile, both the headline and the core CPI rose by 0.2% in July. This left annual inflation edging up last month, with the headline rising to 2% from 1.8% and the core up to 1.7% from 1.6%. Inflation remains modest, but recent reports should ease concerns at the Fed that inflation might fall to undesirably low levels. Meanwhile, manufacturing data was soft, with the Empire State and Philly Fed surveys edging down in August. Nevertheless, the strong signs we are seeing of accelerating domestic demand, helped by the firming labour market, strengthening private sector balance sheets, easing bank lending standards, a slowing pace of fiscal consolidation and ongoing strength in the housing market, suggest softness in the production numbers is likely to be noise rather than trend.

Initial jobless claims

000s



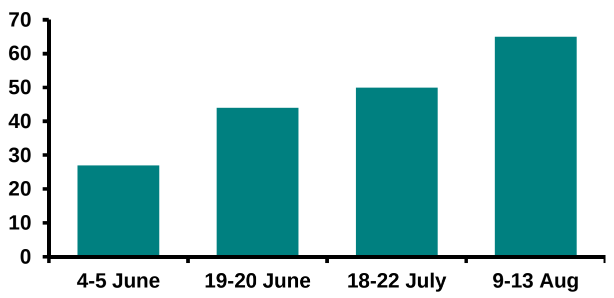
Source: Thomson Reuters Datastream

Fed Watch

The strong jobless claims numbers and the tick-up in inflation, come on top of a range of upbeat US economic data, which suggest that the FOMC is likely to announce a gradual slowdown in the pace of its asset purchases at its meeting on 19-20 September. This remains our central scenario, though of course it is not a done deal. There are still key August economic reports – such as the ISM indicators and the labour market data – that could still delay such a move from the central bank. However, if the ISM reports were to broadly hold on to their July gains, while nonfarm payrolls rebound to 200K or above (which seems likely given the jobless claims) then a September tapering would be pretty much a done deal. The latest Bloomberg survey of analysts, suggests that an increasing majority (65% according to the 9-13 August survey) see the Fed beginning to slow the pace of purchases next month.

Bloomberg survey of economists

%, proportion expecting September tapering of asset purchases



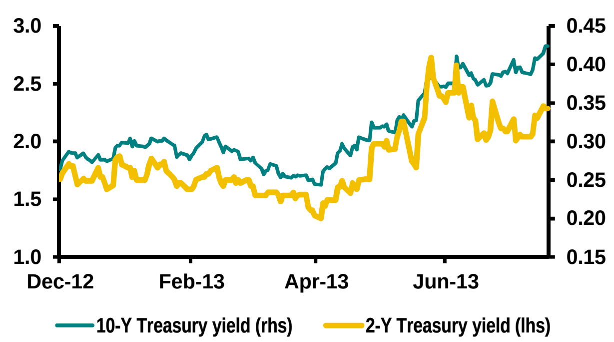
Source: Bloomberg

Interest rates

Treasuries were hit by the economic data as financial markets priced in a bigger probability of a September taper. However, we do not expect the aggressive Treasury sell-off to continue despite our scenario that the FOMC will indeed start to reduce the pace of its asset purchases next month. The central bank is set to take its foot gradually off the accelerator, while rate hikes will not follow for some time. Given this, we expect the Fed to step in and try to rein in Treasury yields if they rise too much and too fast, because the last thing it wants is an early tightening of financial conditions. As such, we think Treasury yields will flatten out in the near term as stronger economic data is balanced out by a Fed campaign to dampen expectations of early rises in policy rates. Looking further forward, with the economy gaining further momentum, and as we move a little closer to eventual central bank exit policies, we should see a second leg up in long-term interest rates next year.

US Government bonds

%



Source: Bloomberg

Asia - Economy & FX

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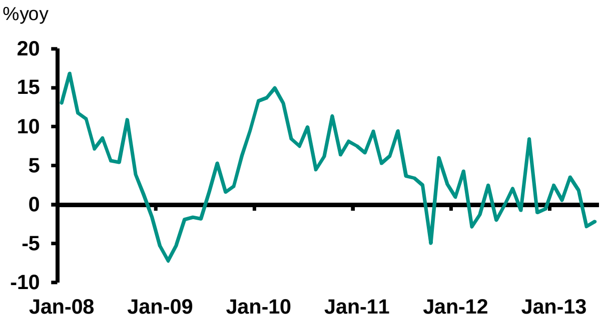
India

India: Industrial production

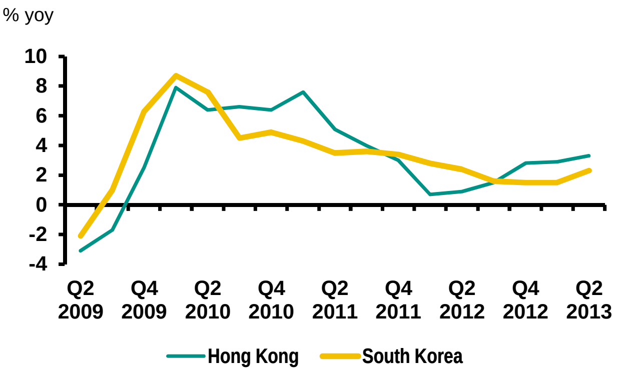


Source: Thomson Reuters Datastream

The Indian authorities introduced a number of measures in an attempt to support the currency last week. In addition to another hike in the import duties of gold, the Finance Minister committed himself to reducing the current account deficit to USD 70bn (3.7% of GDP) in FY 2014 from USD 88bn (4.8% of GDP) last year. This should make the deficit more viable given the difficulties in filling the financing gap, in a context of weakening data. June's industrial production continued to lose momentum, while July's whole sale price inflation increased to 5.8% from 4.9% the previous month. The trade deficit continued to narrow for the second month in a row on the back of stronger exports and quantitative measures to control the import of gold. At the end of the week, the Reserve Bank of India announced further measures to restrict capital outflows. These limit the amount of overseas investments, as well as the quota on remittances under the liberalised remittances scheme, and prohibit the acquisition of property abroad through this scheme. More convincing structural measures are needed to improve confidence.

Other Asia

South Korea and Hong Kong: GDP

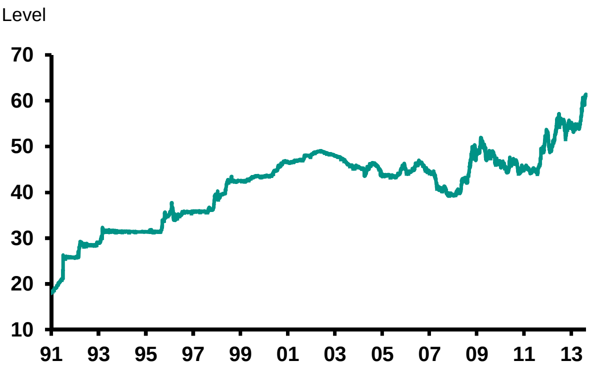


Source: Bloomberg

GDP data released so far shows that activity is picking up modestly in the second quarter in several Asian countries. Hong Kong's second quarter GDP strengthened to 3.3% yoy up from 2.9% yoy in the previous quarter. Net exports had a slight negative impact on growth, while fixed capital formation improved notably, after showing a negative contribution in the first quarter. The contribution of private consumption moderated somewhat in the second quarter compared to the first. Our GDP forecast for 2013 is 3.0%. Meanwhile, South Korea's GDP released some weeks ago rose to 2.3% yoy up from 1.5% yoy the first quarter led by strong construction and government spending, while other fixed investment is still being affected by weak business sentiment. We forecast 3% growth for 2013. Finally, Singapore's second quarter GDP also edged up to 3.8% from 3.7% the previous quarter. In general, we think that global activity should improve gradually in the second half of the year, supporting economic activity in Asia.

CNY & INR

USD/INR

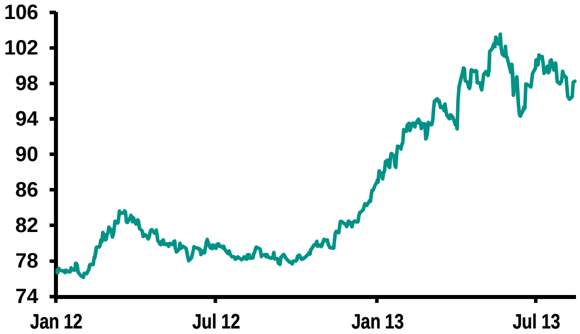


Source: Bloomberg

Asian currencies have fallen under pressure again. Our Asian top-pick Chinese yuan (CNY) has been the exception, strengthening modestly versus the USD. The CNY is perceived as a relatively safe investment compared to Japanese yen (JPY) and Indian rupee (INR). Renewed weakness in the JPY hurt the overall Asian sentiment and increased fears about its impact on the exports of other Asian countries. In addition, the slide of the INR continued despite the government's and Reserve Bank of India's efforts to stop it. Indeed last week, the RBI introduced new measures to halt the INR sell-off. So far they have not been able to convince financial markets. We think that financial markets will continue to test authorities until meaningful measures are taken. Some have placed their hopes on the new central bank governor Rajan who will take charge on 4 September. If he is not able to live up expectations INR will remain under pressure.

USD/JPY

Level



Source: Bloomberg

JPY

At the start of last week, Japanese GDP came in below market consensus and this pushed the Japanese yen (JPY) higher. The JPY often strengthens on weaker data and weakens on better data. However, on balance, the JPY fell against the USD late week. It fell under pressure as the spread between US and Japan yields widened due to the better-than-expected US labour market data. Moreover, the JPY moved lower on the news that the Japanese government is weighing a corporate-tax cut. This signals that the authorities are not happy with the momentum in the economy and this could also eventually open the door for additional monetary stimulus. We expect the Bank of Japan to miss its very ambitious inflation target of 2% by a wide margin during the next two years. Consequently, the BoJ will probably have to step up its government bond purchases, which should help the yen to continue to weaken. We see the USD/JPY at 110 at the end of this year and 120 at the end of next year.

Commodity exporters - FX

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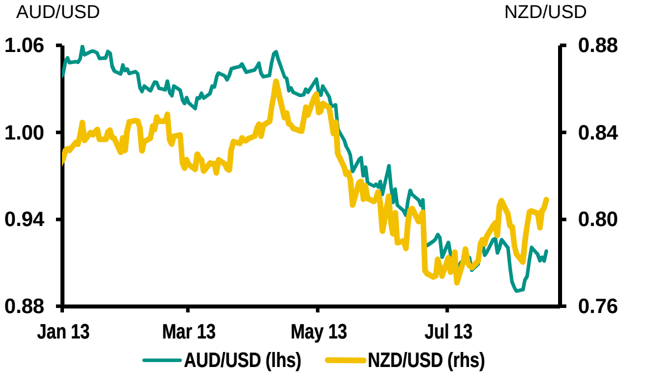
AUD/NZD

At the start of last week, the Australian dollar (AUD) moved lower versus the US dollar driven by a widening interest spread between the US and Australia. However, the view that Japanese investors were searching for yield supported the AUD. The AUD recovered further as the USD gave back its gains. At the end of the week AUD/USD ended around the level it started that week. For this week, the main event will be the RBA minutes. They will likely shed more details on the 25bp rate cut on 6 August. Dovish minutes could push AUD/USD towards 0.90 – our target for Q3 and Q4. NZD outperformed the AUD and the USD last week as better-than-expected economic data continued to push 2-year yields higher on expectations of tighter monetary policy in New Zealand. In addition, still relatively constructive investor sentiment meant that carry-related flows into the NZD continued. The market is somewhat more optimistic on a rate hike than we are. We only expect a 25bp rate increase in Q2 2014. In addition, we are more bullish on the USD. Therefore we are comfortable with our 0.76 in NZD/USD at the end of Q3 and Q4

AUD/USD and NZD/USD

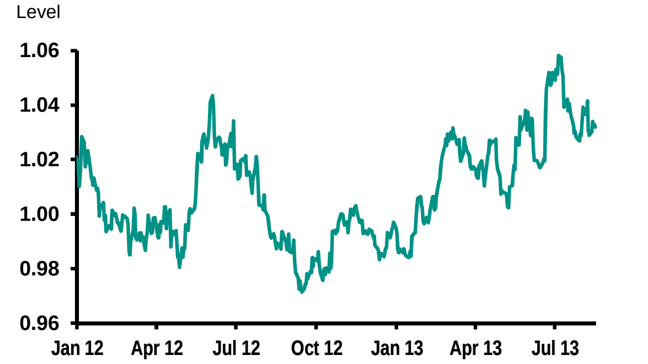


Source: Bloomberg

USD/CAD

At the start of last week, USD/CAD moved higher mainly driven by a higher USD on the back of stronger US data and higher US yields. On Wednesday, the Canadian dollar (CAD) started to recover on the back of better on improving domestic economic data. Initially the USD received support from better US data and higher US yields. But once equity markets started to fall under pressure and equity volatility moved higher, investors sold the USD across the board. As a result, the CAD recovered. We judge that investor worries about Fed tapering and US growth are overdone because the latter will continue to accelerate. The prospect of lower monetary stimulus and strong US domestic growth should be USD supportive across the board. As we expect the Canadian economy to be in an excellent position to profit from the strong US economy and the BoC to exit earlier than the Fed, the CAD is likely to modestly outperform the USD. We keep our forecast that USD/CAD will reach parity by the end of this quarter in place.

USD/CAD

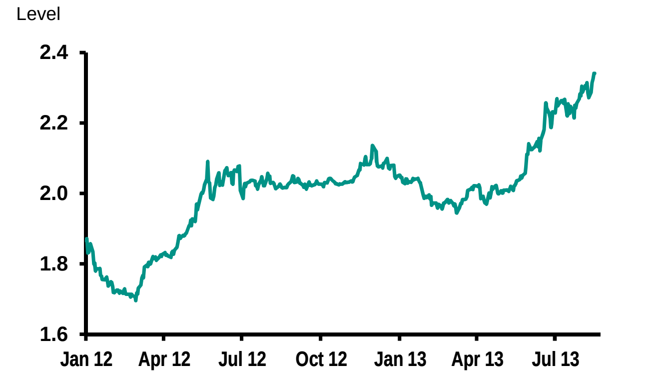


Source: Bloomberg

USD/BRL

The Brazilian real (BRL) was under pressure last week. Stronger-than-expected US data pushed US yields higher. Emerging market currencies often become nervous on higher US yields because it could trigger an EM crisis and/or suggests that US assets are becoming more attractive. In case of Brazil, weaker domestic growth, a widening current account deficit, political uncertainty and assets perceived as unattractive because of inflationary pressures all add to the negative sentiment. The vigilant central bank is expected to continue hiking interest rates because BRL weakness will lead to further inflationary pressures. Such hikes will come at a time that the growth picture is deteriorating. The central bank will continue to intervene in FX markets but it is using swaps without touching FX reserves. So far it has not been able to halt the BRL sell-off. We believe that a stronger medicine is needed to improve the BRL sentiment. We are currently reviewing our BRL forecasts.

USD/BRL



Source: Bloomberg